Asset Allocation

Investing for your retirement



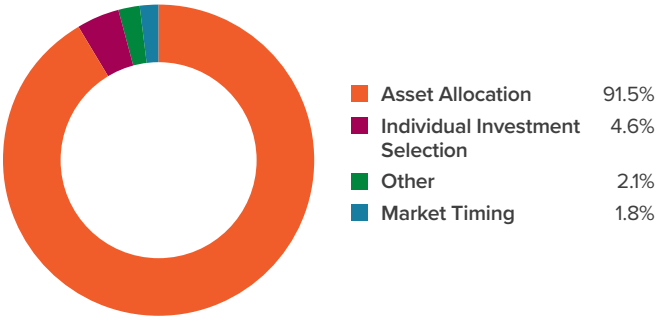
Balancing risk and reward with "class"

Life is full of risks and rewards. For an investor, the reward for taking on risk is the potential to make more money. Of course, the investor can also lose more money. The key is finding a balance between the investor's risk tolerance and reward potential. Asset allocation can help.

A powerful decision

The most significant decision an investor will make when building an investment portfolio is determining the asset allocation.[1] How an investor divides investments among different asset classes can be more important than the actual investment choices made. Finding the right balance between higher and lower risk investments is the key to managing risk in a portfolio. That's the power of asset allocation.

Portfolio performance is determined by:*



* "Determinants of Portfolio Performance II: An Update." Brinson, Singer and Beebower, 1996.

[1] A landmark study, "Determinants of Portfolio Performance," by Brinson, Hood and Beebower, presented in Financial Analysts Journal (May – June, 1992), and its update in 1996, showed that asset allocation decisions, far more than any other factor, affected the long-term performance of an investment portfolio.

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A portfolio with "class"

Asset allocation involves choosing a portfolio by selecting combinations of investments to meet the specific needs and goals of an individual investor. This is done by dividing the portfolio among different asset classes. The three main asset classes that make up a typical portfolio include:

Stocks (equity)
Stocks represent equity or ownership in a corporation. If an investor owns stock in a company, they own a piece of that company. Stocks have historically produced the highest returns; however, they also carry the most risk, with a tendency towards greater price swings – highs and lows – that makes them more volatile than either bonds or money market instruments.

Bonds (income)
Bonds are basically loans in which the borrower agrees to pay back principal, plus interest (income), by a certain time. The borrower's ability to repay typically impacts the bond's rate. Bonds are closely tied to changes in interest rates – i.e., when rates fall, bond prices rise – and are considered less risky than stocks in general.

Money Market (cash)
Money market instruments are investments in short-term debt securities (such as CDs) and government securities (such as Treasury Bills). Like bonds, money market instruments are also tied to changes in interest rates; however, where bond prices tend to move in the opposite direction from interest rates, money market instruments tend to track interest rates.

Historically, market conditions that cause one asset category to do well often cause another category to have average or poor returns. That's why a portfolio that invests in more than one asset category helps reduce the overall risk of losing money.

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A balancing act – time and tolerance

The process of asset allocation is a personal one and varies by investor. If an investor doesn't include enough risk in the portfolio, the investments may not earn enough money to meet an investor's long-term financial goals. If too much risk is included, however, the investor's money may not be there when the investor needs it. The key is finding the right balance between risk and reward that works within the individual investor's time horizon and risk tolerance.

- **Time horizon** – The expected time to achieve a particular financial goal. Investors with longer time horizons, such as retirement, may feel more comfortable taking on riskier investments as they can wait out the inevitable ups and downs of the market; while those with shorter time horizons, such as saving for college, would likely take on less risk.
- **Risk tolerance** – An investor's ability and willingness to lose some or all of his or her original investment in exchange for greater potential returns. An investor with high-risk tolerance is more likely to risk losing money to get better results; while someone with low-risk tolerance tends to favor investments that will preserve the original investment.

Professional modeling

If you want to put asset allocation strategies to work for you, you may wish to consider seeking help from a professional. Financial planners and asset allocation strategists use computer modeling techniques to analyze the risk and return characteristics of asset classes and then construct model portfolios. Questionnaires based on your total financial situation, risk tolerance and goals can also help professionals build a portfolio with the right asset allocation for you.

Of course, using asset allocation as part of individual's investment strategy neither assures nor guarantees better performance and cannot protect against loss in declining markets.

Asset Allocation vs. Diversification

Asset allocation is often confused with diversification, which can be summed up as "not putting all your eggs in one basket." While both help to manage risk, asset allocation takes the concept a step further. Asset allocation involves dividing a portfolio among and within different asset classes (such as stocks, bonds and money market instruments). Diversification only involves the investor spreading his/her dollars among a variety of investments, but doesn't necessarily have to involve different asset classes.



Talk to your financial professional for more information about asset allocation, or the benefits of asset allocation funds

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